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IN THE

Supreme Court of the United States

OCTOBER TERM, 1972

No. 72-486

FEDERAL POWER COMMISSION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

No. 72-488

TEXAS GAS TRANSMISSION CORPORATION, *Petitioner*

v.

MEMPHIS LIGHT, GAS AND WATER DIVISION, ET AL.

On Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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REPLY BRIEF FOR RESPONDENT MEMPHIS LIGHT, GAS AND WATER DIVISION

STATEMENT OF THE CASE

This case arises under the Natural Gas Act, 15 USC 717 *et seq.*, pursuant to a filing by Texas Gas Transmission Corporation (Texas Gas) a natural gas pipe line company, of an increase in rates for natural gas sold to its jurisdictional customers for resale in interstate commerce. The Memphis Light, Gas and Water

Division (Memphis), a municipally owned distributor of natural gas and a city-gate customer of Texas Gas, intervened in the proceedings in the Commission.

All issues before the Commission were settled by agreement by most of the parties, except for the issue of the proper allowance in Texas Gas' cost of service for federal income taxes. It was stipulated among the parties that the dollar effect of the income tax issue on the agreed-upon cost of service would be $4,400,000 per year to Texas Gas' jurisdictional customers.

After a trial before the Administrative Law Judge, the Commission on June 3, 1970 issued its Opinion No. 578, (R. 100-111), followed by its denial of rehearing on July 21, 1970. (R. 145-149). In Opinion No. 578, the Commission authorized Texas Gas to abandon the use of liberalized depreciation with flow-through ("flow-through") and to adopt the use of liberalized depreciation with normalization ("normalization"). Under the Commission's decision Texas Gas pays federal income taxes on the basis of a deduction for depreciation based on liberalized depreciation, but for rate making purposes its rates are based on the higher tax payments which would have resulted had Texas Gas taken a tax depreciation based on the use of straight-line depreciation.

The Commission based its decision squarely upon Section 441(a) of the Tax Reform Act of 1969 (which became § 167(*l*)(4)(A) of the I.R.C.). It held:

(1) That Texas Gas had the right, pursuant to the election provision of subsection (*l*)(4)(A), to switch from flow-through depreciation with respect to its expansion properties (i.e. post-1969 properties which in-

crease the productive or operational capacity of the taxpayers and do not represent the replacement of existing property), and the company proposed to do so (R.105-6, 108);[1]

(2) That since Texas Gas was now entitled to retain the tax savings resulting from the use of liberalized depreciation with normalization on its post-1969 expansion properties, it followed that no tax savings resulting from liberalized depreciation on any of the company's property were any longer available to offset declining depreciation deductions with respect to its non-expansion properties (i.e. existing or pre-1970 and replacement properties) (R. 108).

(3) That as a result, the depreciable plant represented by the pre-1970 properties and replacements thereto would not be stable, but declining, and in the absence of any available offsets from higher depreciation deductions on expansion properties, would in the future result in higher taxes (R. 108);

(4) That these consequences flowing from the Tax Reform Act removed the basis of the Commission's former decisions in *Alabama-Tennessee Natural Gas Co.*, 31 FPC 208 and *Mid-Western Gas Transmission Co.*, 36 FPC 61, (which required regulated utilities to flow through their savings from liberalized deprecia-

[1] Memphis took issue with the action of the Commission in Order No. 404 in which it announced that it would permit regulated companies to use normalization if they exercised the election of §167 (*l*)(4)(A) and abandoned flow-through as to expansion property. Memphis felt the Commission should discourage, rather than encourage, such an abandonment. The Court of Appeals upheld the Commission's Order No. 404 and Memphis' Petition for a Writ of Certiorari was denied by this Court. *Memphis Light, Gas and Water Division* v. *Federal Power Commission*, No. 72-96.

tion) and as a practical matter required the Commission to permit Texas Gas to normalize its tax depreciation on all its properties and, therefore, to increase its jurisdictional rates by the stipulated figure of $4,400,000 per year (R. 108).

Memphis and the Public Service Commission for the State of New York petitioned the United States Court of Appeals for the District of Columbia for review. That court reversed the Commission, holding that the effect produced by the Commission's ruling was precisely the opposite of that contemplated by Congress in the enactment of the Tax Reform Act of 1969 (FPC App. to Pet. 29-39).

The Commission and Texas Gas each petitioned for certiorari, and both petitions were granted and consolidated for briefing and oral argument.

ISSUES

1. Was it the intent and purpose of Congress, in the enactment of § 441(a) of the Tax Reform Act of 1969, to create a regulatory situation such that, if a regulated utility exercised the election therein provided to it to take liberalized deprciation with normalization with respect to its post-1969 "expansion" properties, the regulatory commission would be placed under the practical necessity of permitting such utility to abandon liberalized depreciation with flow-through with respect to all of its existing and replacement properties, thereby necessitating immediate and substantial utility rate increases?

2. Does the Federal Power Commission, under the Natural Gas Act (and irrespective of the Tax Reform Act of 1969), in establishing rates for regulated utilities, have the discretion to make an allowance for fed-

eral income tax expense which is in excess of the taxes actually incurred and paid by the utility?

3. Where a regulated utility exercises the election provided in § 441(a) of the Tax Reform Act of 1969 to change to liberalized depreciation with normalization with respect to its post-1969 "expansion" properties, remaining on liberalized depreciation with flow-through for all its existing and replacement properties, is it necessary to segregate the tax savings with respect to depreciation on expansion properties so that they will not be available to offset the declining depreciation deductions on the existing and replacement properties?

SUMMARY OF ARGUMENT

The result reached by the Court of Appeals is in perfect accord with the intent and purpose of the Tax Reform Act of 1969, § 441(a), and the contrary result of the Federal Power Commission brings about the very consequences which Congress sought to avoid.

The intent and purpose of the Tax Reform Act was to "freeze" current depreciation practices of regulated utilities, so as to arrest the trend among regulatory agencies to force utilities to switch from straight-line or "normalized" tax depreciation to a "flow-through" of liberalized tax benefits to their customers, thus reducing tax revenues. Congress was careful to accomplish this limited purpose in such way as not to cause the substantial utility rate increases which would flow from a sudden switch to straight-line or normalized tax depreciation on all regulated utility properties. It accepted a Senate amendment allowing utility taxpayers an election to change to normalized (or straight-line) depreciation, but limited this election to "expansion" property, acquired after December 31, 1969,

which increases the taxpayer's productive capacity and is not replacement of existing property. Such expansion property, starting at zero, would increase only gradually over the years.

The Court of Appeals' holding permitted Texas Gas Transmission Corporation to adopt normalized depreciation as to its expansion property, but not as to its non-expansion property. This accomplished fully the stated Congressional purposes and avoided the consequences which the legislative history shows Congress desired to avoid.

In its reversal of the Federal Power Commission, the Court of Appeals used as one of its grounds the legal principle that only income taxes actually incurred and paid should be included in a utility's cost of service for rate-making purposes. This principle has repeatedly and consistently been recognized by this Court and United States courts of appeals.

The Commission's opinion, which was reversed by the Court of Appeals, has allowed Texas Gas to normalize its tax depreciation with respect to its entire depreciable plant, thereby resulting in an immediate rate increase of $4,400,000 for that item alone. It based its decision upon its interpretation of the Tax Reform Act, although the decision brought about the very consequences which Congress, as indicated in the legislative history, had tried to avoid and believed it had avoided.

The Commission's basic error was its conclusion that the exercise by Texas Gas of its election to use normalized tax depreciation as to its then non-existent post-1969 expansion properties destroyed the basis for requiring a flow-through of liberalized tax depreciation

benefits. The Commission thought that the change in procedures as to expansion property rendered the larger liberalized depreciation benefits related to new property "unavailable" to be used to offset declining depreciation deductions on older properties. This was error, for the reasons that (1) the change to normalized depreciation as to Texas Gas' expansion properties did not reduce Texas Gas' tax deductions but only increased its revenues, (2) the tax savings resulting from liberalized depreciation were required to be placed in an account the purpose of which was to offset declining deductions on older properties, and (3) the tax changes relative to new expansion properties will in any event be *de minimis* for the next several years.

Even if the Commission's analysis of the Tax Reform Act was correct, it was error to permit the change in tax depreciation practices at the time of the Commission proceedings, because the provisions of the new Act relative to expansion property did not become effective until the end of the first tax year ending after December 31, 1970.

ARGUMENT

I.

THE INTENT AND PURPOSE OF SECTION 441(a) OF THE TAX REFORM ACT OF 1969 WAS NOT TO REQUIRE THE ABANDONMENT OF THE FLOW-THROUGH OF LIBERALIZED DEPRECIATION BENEFITS WITH RESPECT TO NON-EXPANSION PROPERTY, BUT IN GENERAL TO "FREEZE" CURRENT TAX DEPRECIATION PRACTICES.

A. The Language of the Act Contemplates the Retention of Flow-Through Depreciation as to Non-Expansion Property.

The primary inquiry in the construction of a statute is to the provisions of the Act itself.[2] The Act in ques-

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[2] *United States* v. *Public Utilities Commission of California*, 345 U.S. 295, 314.

tion is an addition to § 167 of the Internal Revenue Code (26 USC § 167) which provides for reasonable allowances for depreciation in computing federal income taxes. With respect to "public utility property" as defined in the Act, the term "reasonable allowance" is defined to mean:

(1) A subsection (*l*) method, which for present purposes is a straight-line method;

(2) Liberalized depreciation with normalization (referred to in the Act as "the applicable 1968 method" with respect to pre-1970 property, and as "any method otherwise allowable under this section" with respect to post-1969 property.)

(3) The flow-through method, if the taxpayer used that method in its July, 1969 accounting period.

In Section 167(*l*)(4)(A) the taxpayer is given an election, to be exercised only within 180 days of the passage of the Act, with respect to "expansion property" of the taxpayer, i.e. post-1969 property which increases its productive or operational capacity and does not represent replacement property. If it makes the election, the flow-through method ceases to be a "reasonable allowance" for such property.

The language of the Act itself, therefore, expressly provides for the retention of the flow-through method, both as to pre-1970 and post-1969 property where that method was already in use in July, 1969. The election to abandon flow-through is expressly limited to a very minor portion of the taxpayer's post-1969 property. That portion represents only a part of the properties acquired after December 31, 1969. The expansion properties would start at zero and grow slowly each

year. In view of the gas shortage, it is to be expected that expansion properties which increase the utility's capacity can be expected to remain minor for several years at least, and the effect of the election upon the utility's taxes and gas rates will be negligible, so far as they relate to expansion properties alone.

From the face of the Act itself, it is impossible to find an intent to bring about the abandonment of flow-through depreciation with respect to the bulk of the properties of the compánies already using that method. The major change to be gleaned from the language of the statute is the prohibition of a switch, after July, 1969, from straight-line or normalization to flow-through. The only language which expressly provides for a change in depreciation method is the election provision restricted to expansion property.

B. The Purpose of the Act Was To "Freeze" the Current Depreciation Practices, So as To Arrest the Trend from Straight-Line or Normalization to Flow-Through.

The background reason for the passage of § 441(a) is clearly spelled out in the General Explanation of the Tax Reform Act of 1969 (H. R. 13270, 91st Cong. Public Law 91-172), prepared by the Staff of the Joint Committee on Internal Revenue Taxation, at pages 150-151:

> *General reasons for change.*—The trends of recent years are shifts from straight line to accelerated depreciation and shifts from normalization to flow-through, often against the will of the taxpayer utilities. In general, flow through to customers doubles the tax revenue loss involved in shifting from straight line to accelerated depreciation. It is understood that continuation of these

trends would shortly lead to annual revenue losses of approximately $1.5 billion. The Congress believed that such a revenue loss from this item would be unacceptable at this time. On the other hand, a rule requiring all such utilities to shift to straight line depreciation would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products or services and their attractiveness to equity investors. Consideration of legislative action in this area also is complicated by the fact that many utilities do not have effective monopolies while others do, many utilities are in growing industries while others are losing ground, and many utilities compete (to the extent they face any competition) only with other regulated utilities while others compete with businesses not subject to governmental rate regulation.

In light of the factors outlined above, the Congress concluded that it is appropriate in general to 'freeze' the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more flourishing utility industries. No change was made by this provision of the Act regarding utility industries whose members are generally earning well below their permitted rates of return.

The Joint Committee's concept of the Act as "freezing" the current situation finds support in the separate reports of each House of Congress as the Bill passed through its committees. The House Report on the Bill states:

Accordingly, your committee has determined in general to 'freeze' the current situation regarding methods of depreciation in the case of those companies in what are, by and large, the more

> healthy utility industries. (H. Rep. No. 91-413 [to accompany H. R. 13270] 91st Cong., 1st Sess., p. 132.

The Senate Report concurs:

> Accordingly, the committee agrees with the House that it is appropriate to in general 'freeze' the current situation regarding methods of depreciation . . . (Senate Rep. No. 91-552, 91st Cong., 1st Sess., p. 172).

The effect of the Bill, as explained by the Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, was as follows:

> The bill substantially forestalls the entire revenue loss that the continuation of existing trends would have made almost inevitable. It does so in a way that (with very few exceptions) will require no increase in utility rates because of the tax laws, since by and large, it merely takes the various regulatory situations as it finds them and freezes those situations. (Joint Committee Summary of the Tax Reform Bill, p. 73).

The relevant legislative history is totally consistent with the language of the Act. Both make clear that the Congress had no intent to interfere with flow-through depreciation practices already in effect. The purpose was to prevent further development of the trend of changes from other methods to the flow-through method. This was to be accomplished by simply "freezing" the existing situation with respect to existing property. The only "change" intended by the Act was in fact a prohibition against change in depreciation methods, rather than a requirement of a different method.

II.

IN ENACTING THE TAX REFORM ACT OF 1969, CONGRESS INTENDED TO AVOID THE CONSEQUENCE OF IMMEDIATE SUBSTANTIAL RATE INCREASES.

The legislative history of the Tax Reform Act of 1969 makes it clear that Congress intended to accomplish its objective in such a way as to avoid immediate, substantial rate increases, and that Congress thought it had done so when the Act was passed.

When the Bill was before the House, the Chairman of the Federal Power Commission suggested that the problem be solved by putting all regulated utilities on straight-line depreciation. (H. Rep. No. 91-413, 91st Cong., 1st Sess., p. 132). This would have resulted in the maximum increase in revenues to the Treasury. But the House was unwilling to take a step which would result in substantial rate increases to consumers. The Report states:

> Consideration has been given to suggestions by the Federal Power Commission and others that regulated utilities no longer be permitted to use a method of depreciation other than straight line. However, your committee concluded that, in too many cases, this would place regulated utilities at an unfair competitive disadvantage, both in terms of the sale of their products and their attractiveness to equity investors. *Also, this would result in prompt, substantial and widespread utility rate increases.* (Id. Italics supplied)

It was not anticipated that the Act contemplated by Congress would cause any substantial rate increases. As pointed out above, the Summary of the Bill, prepared by the Staffs of the Joint Committee, expressly advised that the bill would accomplish its objective of forestalling further revenue losses

> . . . in a way that (with very few exceptions) will require no increase in utility rates because of tax laws . . . (p. 73).

At one stage in the progress of the Bill, an amendment was proposed and included in the Senate version which would have indeed caused substantial rate increases. The Senate's original version of the election provision of Section 167(*l*)(4)(A) was as follows:

> (4) Special Rules As To Flow-Through Method. —For purposes of determining whether or not a taxpayer used a flow-through method of accounting for its July, 1969 accounting period with respect to any property.
>
> (A) In applying paragraph (1)(B) or (2)(C) for taxable years beginning after December 31, 1970, the taxpayer shall be deemed not to have used such method if it has so elected within 180 days after the enactment of this subsection in the manner prescribed by the Secretary or his delegate.

By including the reference to paragraph (1)(B), the Senate amendment would have opened the door to abolition of flow-through as to all property (i.e. pre-1970 and post-1969). But this amendment to the bill was rejected. As the Conference Report stated with respect to the final version

> . . . the 180 day election . . . is modified to apply to new property and not to replacement property. Even in the case of new property, however, the right to change over from the flow-through method is available only to the extent the new property increases the productive or operational capacity of the company. (Conf. Rep. No. 91-782, 91st Cong., 1st Sess., p. 313).

Congress has, therefore, carefully considered the prospect of permitting the abolition of flow-through as to all property and has expressly rejected it.

This fact answers Texas Gas' argument (TG Br. pp. 60-61) that Congress, despite the statement of the Joint Committee that the Bill would require no increase in utility rates, actually anticipated that it would do so after the election provision was added. The fact is that the election provision was deliberately trimmed down to apply only to a class of property which would be non-existent when the Act first became effective and would build up slowly over a period of years. The only conceivable reason for this trimming down was to avoid prompt, substantial, widespread rate increases.

III.

THE HOLDING OF THE COURT OF APPEALS ACCOMPLISHES THE CONGRESSIONAL INTENT.

The holding of the Court of Appeals is that the Commission allowance of the abolition of flow-through as to all of Texas Gas' property, with a consequent immediate increase in rates, is not consistent with the intent and purpose of the Tax Reform Act.[3] It held that the Commission may not make an allowance in Texas Gas' rates for anything other than taxes actually paid, except in the case of expansion property.

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[3] The Commission since Opinion No. 578 was issued has been deluged by rate increase filings in which substantial portions of the rate increase are based on the reversion from flow-through to normalization. To cite a few: Consolidated Gas Supply Corporation, Docket No. RP69-19, in which the annual impact is $6 million; Tennessee Gas Pipe Line Company, Docket No. RP71-6, in which the annual impact is $13 million.

This accords perfectly with the announced Congressional policy of avoiding prompt, substantial rate increases as a result of the Act, and it is completely consistent with the concept of the Act as a "freeze" of current depreciation practices.

IV.

THE RATIONALE OF THE COURT OF APPEALS ACCORDS WITH PRECEDENTS RELATED TO ALLOWANCE OF TAXES IN COST OF SERVICE.

The aspect of the holding of the Court of Appeals which is most strongly attacked by the Commission and Texas Gas is the court's conclusion that the Tax Reform Act affirmatively limits the Commission's discretion to permit abandonment of flow-through in favor of normalization. This holding is ably discussed by the court below and is persuasively defended in the brief of the New York Public Service Commission.

There is, however, another aspect of the Court's holding to which neither petitioner has addressed itself. The Court's result does not require as a foundation a conclusion that the new Act further limits the Commission's discretion as to tax allowances. The decision of the court below is amply supported by its further holding that

> There is nothing in the Tax Reform Act of 1969, then, which modifies the Commission's duty under the Natural Gas Act to require regulated utility companies such as Texas Gas which has been using liberalized depreciation with flow-through with respect to their pre-1970 and post-1969 nonexpansion property to set rates which reflect actual expenditures alone with respect to such property. According to Congress the only appropriate tax

allowance for ratemaking purpose for a company such as Texas Gas, which has been using liberalized depreciation with flow-through with respect to its pre-1970 and post-1969 non-expansion property, is the income taxes actually paid. (FPC, App. A to Pet., p. 36).

The Commission, *under the Natural Gas Act,* has a duty to require the setting of rates which *reflect actual expenditures alone,* and the only appropriate tax allowance for ratemaking purposes is *the income taxes actually paid* (except for depreciation on expansion property). Therefore, the court's result must be correct, for it provides for the allowance of actual taxes, except for depreciation on expansion property.

The Petitioners' positions herein rest on the contention that, independently of the Tax Reform Act, the Commission has unfettered discretion as to whether it will allow in cost of service the taxes actually incurred and paid or a fictitious tax element based on normalization. This represents a dramatic change of position for the Commission. In its landmark Opinion in the first *Southern Louisiana Area Rate Case,* the Commission stated:

> It is an essential precept of regulatory law that no income tax allowance should be permitted except for taxes actually paid. *F.P.C.* v. *United Gas Pipe Line Co.,* 386 U.S. 287 (1967); *El Paso Natural Gas Co.* v. *FPC,* 281 F.2d 567, 573 (CA5-1960), certiorari denied *sub nom, California* v. *FPC,* 366 US 912 (1961); *Alabama-Tennessee Natural Gas Co.* v. *FPC,* 359 F.2d 318 (CA5-1966), certiorari denied 385 US 847 (1966). Where this Commission has provided an allowance for taxes which were not actually paid, it has been reversed. *El Paso Natural Gas Co.* v. *FPC, supra,* reversing 22 FPC 260, 267 (1959) (40 FPC 530, 581).

The Commission has a regulatory duty to allow only actual taxes, and it can point to nothing in the language of the Tax Reform Act which relieves it of that duty, except with respect to depreciation on expansion property.

The Commission's assumption of an unfettered discretion as to tax allowance treatment is based, in its brief herein, first, on general judicial statements as to the breadth of its discretion, and, second upon its record of affirmance on both sides of the tax normalization question. (FPC Br. pp. 16-18). A close examination of the authorities indicates, however, *that they have never departed from the principle that only actual taxes should be used in the cost of service.*

The Commission quotes *Federal Power Comm.* v. *Natural Gas Pipeline Co.*, 315 U.S. 575, 586, for the proposition that the Commission is not bound to "any single formula or combination of formulas," but is "free . . . to make the pragmatic adjustments which may be called for by particular circumstances." It does not at all follow that the Commission, having chosen the actual cost of service as its method for making rates, is then free to allow a cost element which is not in fact a real expense. In *FPC* v. *United Gas Pipe Line Company*, 386 U.S. 237, 244, cited by the Commission in support of its position, this Court said:

> Nothing in Colorado Interstate[4] or Panhandle[5] forbids the Commission to recognize the actual tax saving impact of a private election to file consolidated returns. On the contrary *both cases support the power and the duty of the Commission to limit the cost of service to real expenses.* (Italics added; footnotes added)

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[4] *Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581.

[5] *Panhandle Eastern Pipe Line Co.* v. *FPC*, 324 U.S. 635.

In that case this Court affirmed the Commission's action in requiring United Gas Pipe Line Company to flow through to its customers the tax savings realized by it as a result of its election to file a consolidated return with its affiliated companies.

The first of a series of cases dealing with proper income tax allowances in the cost of service of natural gas companies is *El Paso Natural Gas Co.* v. *FPC*, 281 F.2d 567 (CA 5, 1960), cert. denied, 366 U.S. 912, 6 L. Ed.2d 236, 81 S.Ct. 1083. That case involved principally the treatment of special tax savings from depletion and intangible drilling expenses, realized by the pipeline company from its production activities. The Fifth Circuit in that case held, reversing the Commission, that only federal income taxes that had actually been paid for the test year were to be treated, for rate purposes, as part of the cost of service. This was clearly regarded by the Fifth Circuit as a matter of law. The court said:

> We think, in short, that there is no statutory authority for the Commission to treat actual savings in taxes to which natural gas companies are entitled any differently than savings in any other cost of service. It is the obligation of all regulated public utilities to operate with all reasonable economies. This applies to tax savings as well as economies of management. The net result of this, of course, is that such savings as are effected are passed on to the consuming public. This we consider to be the natural and necessary consequence of rate regulation.[6]

[6] The Court reached the opposite result on the question of normalizing the company's liberalized depreciation tax savings. However, it did so under the then current impression that the savings were only a deferral and that they represented an actual expense in the long run.

In *Alabama-Tennessee Natural Gas Co.* v. *FPC*, 359 F.2d 318 (CA 5, 1966), cert. denied 385 U.S. 847, the court, affirming the Commission's requirement that tax depreciation benefits be flowed through, discussed the regulatory concepts which underlie the requirement that only actual taxes be allowed in cost of service. The court said:

> Under traditional regulatory concepts, utility company shareholders (investors), not the consumer, furnish the capital necessary for the operation of the business. *Railroad Commission of Louisiana* v. *Cumberland Telegraph and Telephone Company*, 1909, 212 U.S. 414, 424, 29 S.Ct. 357, 53 L.Ed. 577; *Lindheimer* v. *Illinois Bell Telephone Company*, 1934, 292 U.S. 151, 169, 54 S.Ct. 658, 78 L.Ed. 1182. The consumer pays a fair return on the utility's capital and in addition pays the costs of operation including taxes, but:
>
> '. . . [I]f the amounts charged to operating expenses and credited to the account for depreciation reserve are excessive, to that extent subscribers . . . are required to provide, in effect, capital contributions . . . to secure additional plant and equipment upon which the utility expects a return.' *Lindheimer*, 292 U.S. at 169, 54 S.Ct. at 665.

Where the plant of the regulated utility is growing or stable, the use of normalized depreciation will provide a permanent tax savings which is in effect a forced contribution of capital by the ratepayers. This, as the Fifth Circuit held, is a violation of "traditional regulatory concepts."

The next in the same line of cases was *City of Chicago* v. *FPC*, 385 F.2d 629 (CADC 1967), which again affirmed the Commission's requirement of flow-through, pointing out (385 F.2d at 633) that

> The general rule followed by the Commission, and indeed most if not all regulatory commissions, is that the 'consumers should be charged for only the actual liability for Federal income taxes'. (Citing United Fuel Gas Co. 12 FPC 251, 265).

Midwestern Gas Transmission Co. v. *FPC,* 388 F.2d 444 (CA7 1968), is to the same effect. This opinion affirmed the action of the Commission in *imputing* liberalized depreciation with flow-through to Midwestern, when that company switched to straight-line depreciation after the *Alabama-Tennessee* decision. The court expressed itself as "in complete agreement" with *Alabama-Tennessee.*

Both the Commission brief (p. 17) and that of Texas Gas (pp. 63-64) infer from the case of *City of Lexington* v. *FPC,* 295 F.2d 109 (CA4, 1969), that the Commission has full discretion to go either way on the flow-through vs. normalization issue. This is a misconstruction of the cases. It is true that *City of Lexington* affirmed the Commission in allowing a pipe line to normalize its taxes. But this was done at a time when the Commission was laboring under the factual misapprehension that liberalized depreciation tax benefits were only a deferral, rather than a saving of taxes, and under a legal misapprehension of the construction of Section 167 of the Internal Revenue Code. In *City of Lexington,* the court pointed to the Commission's *finding of fact* "that the normalization method does not result in a tax saving but only a tax deferral" and that the Commission "was acting within its province as a trier of fact." (295 F.2d at 113). The court made it clear that this factual determination, within the Commission's area of "expert skill", was the controlling factor in the case. (295 F.2d at 114). The court's ad-

herence to the actual taxes principle was clearly expressed in the following statement:

> It is pointed out that in such cases as *Galveston Electric Co.* v. *Galveston,* 258 U.S. 388, 42 S.Ct. 351, 66 L. Ed. 678; *Georgia R. & Power Co.* v. *Railroad Commission,* 262 U.S. 625, 632, 43 S.Ct. 680, 67 L.Ed. 1144, and *South Carolina Generating Co.* v. *Federal Power Commission,* 4 Cir., 249 F.2d 755. Id. 4 Cir. 261 F.2d 915, it was recognized that Federal income taxes are a cost of doing business, *but only the amount of taxes actually paid is an expense which should be considered in calculating the rate to be charged to customers.* (Italics supplied)

The opinion is clear that the court did not consider that it was departing from that principle.

By the time of the *Alabama-Tennessee* case, it had become clear that "for ratemaking purposes Section 167 was not a congressional mandate to regulatory agencies to approve normalization" (359 F.2d at 329) as the Commission had supposed, and that "as long as the company continues the use of liberalized depreciation and continues to make at least some capital additions . . . liberalized tax depreciation will always exceed straight-line tax depreciation . . . (Id. at 336). The factual premise underlying the *City of Lexington* decision had thus been demonstrated to have been erroneous.

Therefore, the cases which have upheld normalization [7] do not imply that the Commission has discretion

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[7] In addition to the *City of Lexington* case, there was *El Paso Natural Gas Co.* v. *FPC, supra* (see Note 5) and *Panhandle Eastern Pipe Line Co.* v. *FPC,* 316 F. 2d 659 (CADC 1963).

to depart from the actual taxes principle. They merely followed the Commission's erroneous factual premise that the liberalized depreciation tax benefits were only temporary. Statements by the courts in these cases concerning the Commission's "discretion" and "expertise" will, on close scrutiny, be seen to apply to the area of the Commission's findings of fact in a technical field, and not to imply a discretion to abandon basic regulatory principles inherent in cost-of-service ratemaking.

All of the precedents are consistent in supporting the holding of the court below that the Commission has a "duty under the Natural Gas Act to require regulated utility companies such as Texas Gas . . . to set rates which reflect actual expenditures alone with respect to such [non-expansion] property," and that "the only appropriate tax allowance for ratemaking purposes for a company such as Texas Gas [as to its non-expansion property] is the income taxes actually paid."

There is no evidence in the Tax Reform Act or its legislative history of any intent to change that ratemaking principle as to non-expansion property.[8]

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[8] The Commission brief (pp. 22-23) cites comments in the House and Senate Reports on the Bill to the effect that companies on flow-through would continue on that basis "unless the appropriate regulatory agency permits a change as to that property." Such remarks did not purport to be statements of law defining the powers of the regulatory bodies, and in any event cannot add any provisions to those of the Act itself. The Commission apparently cites them to support its argument that the Act was not intended to "alter the authority of regulatory agencies . . . to permit the abandonment of flow-through." (Br. p. 22) Memphis' point is that the Federal Power Commission has no such authority, in any event, where such abandonment departs from the "actual taxes" principle.

V.

THE COMMISSION'S ALLOWANCE OF NORMALIZATION ON ALL PROPERTY CAUSES THE VERY CONSEQUENCES CONGRESS SOUGHT TO AVOID.

In its consideration of the Tax Reform Act, Congress expressly refused to require utilities to switch to straight-line depreciation, partly because the resulting increase in tax cost would result in prompt, substantial and widespread rate increases (*supra*, p. 12). The Commission's allowance of normalization has an almost identical rate effect as would straight-line depreciation. (The only difference is the deduction of the balance in the reserve from the rate base, under normalization, thus exempting the ratepayers from paying a return on their own capital contribution).[9] The consequence sought to be avoided by Congress has been incurred.[10]

Congress deliberately refused to permit utility taxpayers to elect to switch from flow-through to normalization with respect to non-expansion property. The Commission's rationale makes it incumbent on the Commission to permit normalization on all property, if the utility elected it for its expansion property. In effect, the Commission makes the § 167(*l*)(4)(A) election tantamount to the broader election proposed by the Senate and rejected by Congress.

Thus, both of the consequences which the legislative history shows Congress specifically attempted to avoid have resulted from the Commission's interpretation of the Act.

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[9] Deduction of the reserve balance from the rate base does not sompensate the ratepayers for being deprived of the use of their funds and for the time value of money.

[10] See footnote 3, *supra*.

VI.

THE COMMISSION ERRED IN CONCLUDING THAT TAX DEPRECIATION ON NEW FACILITIES IS NO LONGER AVAILABLE TO OFFSET DECLINING DEPRECIATION ON OLD FACILITIES.

The crux of the Commission's analysis of the effect of the Tax Reform Act is its erroneous conclusion that tax depreciation on normalized expansion facilities will not be available to offset declining depreciation on older facilities and that, therefore, the factual premise underlying the flow-through method no longer obtains. This is the real basis for its decision to abandon flow-through, and it is demonstrably wrong. The Commission's conclusion is expressed as follows (R. 108):

> Under the present circumstances the considerations applicable in *Alabama-Tennessee* and *Midwestern* do not obtain. By reason of Texas Gas' proposed election under the Tax Reform Act and Order No. 404, depreciation on its facilities, constructed after the beginning of 1970 which increase its capacity, will be subject to normalization rather than flow-through. Therefore tax depreciation on such new facilities will not be available to offset the declining tax depreciation deductions on the older facilities as contemplated in the *Alabama-Tennessee* and *Midwestern* cases.

This conclusion is erroneous for several reasons:

1. It postulates that Texas Gas will have *less* protection against future tax increases because it is receiving *more* revenues. Under flow-through on new expansion properties, Texas Gas under the *Alabama-Tennessee* principle, would be protected against a future increase in taxes (because of decreasing depreciation deductions on older property) by the higher deduc-

tions allowed on newly acquired property. This would occur, even though Texas Gas flowed through its liberalized tax benefits on all of its properties. With normalization in effect as to its expansion properties, Texas Gas gets precisely the same income tax benefits, but is not required to pass them on to its customers. Accordingly, Texas Gas' revenues are *increased* by the amount of the increase in rates necessary to normalize as to expansion property. This should give it *more* protection, not less, than it would have had before the change.

2. Tax depreciation on new facilities *is* in fact available to offset declining depreciation deductions on older facilities. The new facilities will become a part of Texas Gas' depreciable plant and will be subject to double declining balance depreciation. The difference in taxes between the liberalized depreciation and straight-line depreciation will go into the reserve account, Account No. 282 of the Uniform System of Accounts. The description of that account provides:

> B. This account shall be debited and Account 411, Incomes Taxes Deferred In Prior Years-Credit, shall be credited with an amount equal to that by which taxes on income payable for the year are greater because of the use in prior years of liberalized depreciation for income tax purposes, and deferral of taxes in such prior years as described in Paragraph A above. . . .

There is nothing in that account description, nor any fact cited in the Opinion of the Commission, nor in its brief in this Court, which prevents tax depreciation on new facilities from being available to offset declining depreciation on old facilities.

Texas Gas attempts to fill this gap by a highly theoretical accounting argument that the increasing taxes related to older property are an expense, which must be offset by "income", and that the liberalized depreciation savings are not technically "income." (TG Br. p. 70). But regardless of accounting terminology, the increased revenues collected to cover the normalized tax allowance are in fact *available* to the company, and when they are placed in Account No. 282, they are *available* to offset increases in taxes resulting from declining depreciation balances.

3. In any event, the practical effect of the normalization of depreciation deductions on expansion property will be *de minimis* for several years. As noted above (p. 9) the expansion property began at zero on January 1, 1970, and, in the light of the current gas shortage, acquisition of properties which "increase the productive or operational capacity of the taxpayer" will probably be at a low level for several years.[11] It is not reasonable to use a depreciation change with respect to a negligible amount of property as a basis for imposing currently upon the ratepayers a large increase in tax allowance relating to the entire utility plant of the company.

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[11] The Internal Revenue Service Regulations permit a taxpayer to compute its expansion property as the difference between the total cost of all new property acquired in the taxable year and the depreciated cost of property retired in the same year. Reg. § 1.167 (1)-4(c). That Regulation is clearly inconsistent with the Act's definition of expansion property. By defining it as all property in excess of retirements, the Regulation arbitrarily assumes that the depreciated cost of retired property equals in dollar value the original cost of all replacement property plus all other additions which do not increase capacity. This is far removed from reality.

The Commission again fell into error when it reasoned that

> Excluding new expansion facilities from consideration, the continued use of liberalized depreciation on the pre-1970 plant will not create a tax saving. (F.P.C. Pet. App. D, p. 62).

There is no necessity, under the Tax Reform Act, for "excluding new expansion facilities from consideration" in dealing with liberalized depreciation. Texas Gas will continue to file a single tax return, and its new expansion facilities will constitute a part of its depreciable plant, and its taxes, so far as depreciation effect is concerned, will be exactly what they would have been prior to the change. The company will continue to take liberalized depreciation on its entire plant. The only change is in its revenues.

The basic error in the Commission's conclusion that the new tax savings will not be "available" and that new expansion facilities must be "excluded from consideration" is its misunderstanding of the Congressional concept of normalization. The Commission defines normalization with respect to expansion properties as consisting of two steps:

(1) the charging of utility rates computed on the basis of straight-line tax depreciation on expansion property, while paying the lower actual taxes based on liberalized depreciation, and

(2) the segregation of the difference between normalized and actual taxes into a kind of escrow, to be held until the time that the tax depreciation *on the expansion property* falls below the straight-line level.

There is nothing in the Tax Reform Act which implies that Congress intended normalization to include the second step. It is clear from the legislative history that the retention of the difference in Account 282 is not required. The General Explanation of the Act by the Staff of the Joint Committee on Internal Revenue Taxation states;

> In some jurisdictions the purpose and effect of normalizing is accomplished by additions to a reserve for depreciation. The Act permits such a definition of normalization and *does not require that additions be to a separate account described as a 'reserve for deferred taxes.'* (p. 152) (Italics Supplied).

Therefore, the Commission's second step—which is the one that creates the problem—is not required by the Act, nor is it germane to the Congressional purpose.

It is true that if the additional revenues obtained from normalizing as to expansion property are used to offset declining depreciation on older properties, then the change in depreciation practices may not substantially increase utility rates for several years. Only when there has accumulated a substantial amount of "expansion" property will a rate effect be felt. But this is precisely what Congress intended and expected.

Congress knew there would be *no* expansion property at the time of the passage of the Act. When it limited normalization to expansion property, it did so for the very purpose of postponing any effect on utility rates.

The Commission's analysis ignores still another element in the definitions included in the Tax Reform Act. The Act permits normalization only as to a minor part of new property acquired after December 31,

1969—non-replacement property which does not increase capacity. In the normal course of events, in light of the fact that the days of burgeoning pipe line expansion are over, most of the new property coming into depreciation base for the foreseeable future will be either replacement property or property which does not increase the productive or operating capacity of the company.[12] Though such new property does not come within the statutory definition of "expansion" property, it will enjoy the benefit of liberalized depreciation, and the tax savings represented by it will be "available" to offset declining depreciation on older properties, even under the Commission's concept. In fact it is not at all certain that such new, non-expansion properties will not generate sufficient tax savings, *by themselves* to offset the "below normal" depreciation on old properties. (This question was not before the Commission at the hearing stage, and there is no evidence whatsover in the record relating to it.)

In order for the depreciation on the new non-expansion properties to offset the below-normal depreciation on older properties, it is only necessary for the non-expansion plant to *remain stable.* As the Commission stated in *Alabama-Tennessee,*

> Even if the composite plant of a company remains stable, where the dollar value of retirements equals the cost of replacements, annual liberalized depreciation will not be lower than straight-line depreciation and the reserve established under normalization will not decline. (31 FPC at 215)[13]

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[12] Synthetic natural gas facilities and liquefied natural gas facilities and coal gasification facilities might fit in the latter category.

[13] The Commission has not retreated from this principle in its present Opinion, *infra,* p. 31.

Under the Tax Reform Act, a company's non-expansion property, by definition, remains at least stable, because it includes all replacement property, as well as additional property which does not increase capacity. Nevertheless, the Commission held that such would not in fact be the case, because "the permissible tax depreciation life of natural gas properties is much shorter than the physical life of such properties." (F.P.C. Pet. App. C, p. 63) This generalization was not supported by any reference to any Internal Revenue act, regulation or authority. It is totally unsupported as a finding related to Texas Gas in particular, because the question was not in issue at the hearing, and there is no evidence whatsoever with respect to it.

In an effort to shore up this gap, Texas Gas (Br., p. 71) inserts a column of figures from its Form 2 (not in this record), showing that its depreciation base is declining much faster than its property is being retired, and that such has consistently been its experience. But those figures (not presented in evidence nor subject to cross-examination or rebuttal) prove nothing about the long-range future. Texas Gas' over-all depreciation rate has been in the range of 3%, but the bulk of its depreciable property is less than thirty years old. It is not to be expected that annual retirements will approximate annual depreciation until the end of the estimated service life of the company's original properties.

Therefore, not only is the Commission wrong as a matter of law in its concept of normalization as to expansion properties, but it is totally unsupported as a matter of fact in its conclusion that non-expansion plant will not in the long run remain stable.

VII.

THE COMMISSION ERRED IN OVERRULING ALABAMA-TENNESSEE AND MIDWESTERN

The Commission, after having started out upon the erroneous assumption that liberalized depreciation was a tax deferral, rather than a savings, and having corrected that error in *Alabama-Tennessee,* now returns full circle to its original discredited position, and explicitly overrules *Alabama-Tennessee* and *Midwestern* (R. 109-110).

The Commission does not attack the correctness of those decisions at the time they were made, but bases its reversal exclusively upon the Tax Reform Act of 1969, saying (R. 109-110):

> Furthermore, upon reexamination of the basis of our *Alabama-Tennessee* and *Midwestern* decisions in light of the Tax Reform Act of 1969, particularly its effect on post-1969 property, and the impact of the tax law and pipeline property, the findings made in those two cases are no longer applicable, and accordingly the cases are overruled to the extent they are inconsistent with this decision.

The Commission makes it clear that its reason for this step is its conclusion above discussed that the normalization of taxes related to expansion properties somehow segregates them from older properties for tax purposes. This is the only basis for the Commission's conclusion that normalization with respect to non-expansion properties "would lead to more stable tax costs in the long run." (Id. p. 63). There is no need to repeat here the deficiencies in the Commission's conclusion.

It should be noted, however, that the Commission did not, either in its Opinion or in its brief in this Court, attempt to argue that its conclusions were derived from the current gas shortage. This effort is made only by Texas Gas (Texas Gas Br., pp. 66-69), but it has no legitimate place in this case. Texas Gas never contended at the hearing that it needed normalized depreciation because of a gas shortage. There is no rational connection between the two and no evidentiary support therefor.

VIII.

UNDER NO CIRCUMSTANCES COULD ANY TAX RELATED RATE INCREASE HAVE BECOME EFFECTIVE IN 1970.

Even if it were assumed that the Commission's analysis of the new tax law was correct with respect to post-1969 expansion property, and were further assumed that the Commission's conclusion was correct with respect to long-run effect of the tax depreciation savings on existing and replacement properties, it has still failed to demonstrate the necessity for its approval of a change to normalized depreciation *at this time* and *in these dockets.* The rate increase in the principal case, Docket No. RP69-41 was filed on June 26, 1969, and was based upon a cost of service for the twelve months ending March 31, 1969, adjusted for known changes to December 31, 1969. The rates became effective in January, 1970.

During the entire test year as adjusted, and at the time the rates became effective, Texas Gas obviously had no post-1969 expansion property whatsover, and the Tax Reform Act of 1969 had no effect at all upon its then-existing system. The election did not become effective as to post-1969 property until the first taxable year beginning after December 31, 1970. Therefore, the increased costs could not, in any event, materialize

during the test period, adjusted. Nevertheless, despite the argument of its own Staff that any changes in tax depreciation policies should await a subsequent decision based upon a test year which showed the effect of the new Act, (Staff Br. to Comm., p. 68) the Commission proceeded to impose a $4,400,000 increase on Texas Gas' customers, effective in January, 1970.

CONCLUSION

The Congressional policy in enacting § 441(a) of the Tax Reform Act, as clearly expressed on the face of the Act and its legislative history, was to arrest the trend toward flow-through depreciation and its double tax loss to the Treasury, and to do so in a manner which would avoid immediate and substantial utility rate increases. The election provision with respect to new expansion property provided a means for a slow and gradual change from flow-through to normalized depreciation practice, which would not disrupt existing utility rate levels.

The judgment of the Court of Appeals accomplishes these purposes, and it correctly reversed the Federal Power Commission, whose Opinion would bring about the consequences Congress sought to avoid.

WHEREFORE, it is respectfully submitted that the judgment of the Court of Appeals should be affirmed.

Respectfully submitted,

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